COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

INVESTIGATION BY THE DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY ON ITS OWN MOTION INTO THE ASSIGNMENT OF INTERSTATE PIPELINE CAPACITY	)	D.T.E. 04-01

INITIAL COMMENTS OF KEYSPAN ENERGY DELIVERY NEW ENGLAND

KeySpan Energy Delivery New England ("KeySpan" or "the Company")[1] hereby submits its initial comments in this investigation by the Department of Telecommunications and Energy (the "Department") into the assignment of interstate pipeline capacity pursuant to Natural Gas Unbundling, D.T.E. 98-32-B (1999).

I. Introduction

In its Order opening this investigation, the Department seeks comments on whether the upstream capacity market is sufficiently competitive to modify the existing mandatory method for upstream capacity assignment to allow for voluntary assignment of such capacity. The Department further requests that comments include information on: 1) the number of transportation customers; 2) the number of marketers; 3) the percentage of the market that has converted to transportation service (both in volume and number of customers); 4) developments at the FERC regarding this matter; and 5) mechanisms by which LDCs can include other affected market participants in an LDC's capacity planning process. Order Opening Investigation on Assignment of Interstate Pipeline Capacity, D.T.E. 04-01, at 3-4 (2004).

[1] The three Massachusetts local distribution companies doing business as KeySpan Energy Delivery New England are Boston Gas Company, Colonial Gas Company and Essex Gas Company.

As a local gas distribution company, KeySpan continues to support customer choice. At this point in time, however, the status of the upstream capacity market is not sufficiently competitive for the Department to modify or change the mandatory capacity assignment method that it previously adopted as part of natural gas unbundling. This conclusion rests on the fact that preconditions established by the Department for a sustainable competitive market have not been met.

II. Preconditions to Reconsidering Mandatory Capacity Assignment

In Natural Gas Unbundling, the Department stated that its goal was "to facilitate the expedient and orderly transition from regulation to competition in the gas supply market." D.T.E. 98-32-B at 25. It cautioned, however, that it will promote competition "only where competition is able to sustain itself. We will not attempt to create a competitive market, if the competitive market cannot develop and exist on its own or would artificially benefit only a narrow group of actors at the expense of others." Id. To achieve that goal, the Department found that it must ensure "(1) that all customers in the Commonwealth will continue to receive reliable service; and (2) that customers will be required to pay for only those costs that the LDC incurred in order to serve them." Id. at 25-26.

The Department's vision of a fully competitive gas industry is one "in which all customers would have the option to purchase both gas commodity and transportation capacity from a wide range of providers operating in a competitive market." Id. at 58. And in such a market, the "LDCs' obligations would be limited to the transportation and delivery of supplies brought to the city gate by competitive third-party suppliers in order to serve the LDC's customers." Id.

But the preconditions of a fully competitive upstream capacity market did not exist at the time of the Department's order in Natural Gas Unbundling. Id. And the Department noted the particular concerns of Massachusetts with the development of the upstream capacity market because the Massachusetts market was winter peaking, situated at the end of the interstate pipelines, and was capacity constrained. Id. at 26. Therefore, it concluded that (i) the LDCs' obligation to serve, i.e., their obligation to "plan for and procure capacity resources," could not, as yet, be eliminated and (ii) the "voluntary assignment of upstream capacity currently would be inconsistent with the LDCs' obligation to provide reliable and least cost service and would result in improper cost shifting among customers." Id. at 58-59.

Furthermore, the Department found that a "slice-of-system" approach is necessary to equitably allocate the costs of mandatory capacity assignment, because this approach would ensure that the customers would pay a pro-rata share of the costs for their pro-rata share of existing capacity necessary to meet their needs. Id. at 34. In turn, by marketers assuming a pro-rata slice of the capacity along with their pro-rata share of the costs, each marketer would be treated equitably, enabling them to compete on a level playing field with other marketers and the LDCs. Id.

In contrast, under the alternative "path" approach, marketers would be assigned capacity along a specific contract path from wellhead to the city gate. The Department found that the alternative "path" approach inequitably would allow customers migrating to transportation service to obtain the least expensive capacity while leaving the more expensive and less desirable capacity behind to burden the customers who remain with the LDC's bundled service. Id. at 34 n.19.

Thus, the Department has found that until there is a fully competitive upstream market, capacity assignment from LDCs to marketers must be mandatory, and as long as mandatory assignment is required, equitable considerations require the application of the "slice-of-system" approach. Id. at 34 and 59.

For mandatory, slice-of-system, capacity assignment to be reconsidered, two preconditions were set forth by the Department: (i) price controls on interstate capacity imposed by FERC must be lifted; and (ii) the number of marketers holding firm rights to interstate pipeline capacity must increase. Id. at 27. As addressed below, neither of these preconditions has been met.

III. The Department's Preconditions Have Not Been Met and, Therefore, No Modification of Mandatory, Slice-of-System, Capacity Assignment is Warranted

A. Introduction

In Natural Gas Unbundling, the Department stated that, in the future, there might be changes to the upstream market and that a five-year period would be adequate to transition to a fully competitive market. Id. at 59. To evaluate whether expected changes took place and whether the market became sufficiently competitive to change or modify mandatory capacity assignment, the Department indicated that it would conduct an evaluation of that market after three years and again after five years. Id.

At this three-year review point, an examination of the present state of the upstream capacity market can only lead to the conclusion that the preconditions specified by the Department as necessary to achieve a fully competitive upstream capacity market have not materialized. Therefore, modification of mandatory, slice-of-system, capacity assignment is not warranted. Doing so at this time would place reliability at risk and shift costs to the LDCs' captive firm sales customers, conditions that continue to be inconsistent with the Department's unbundling objectives.

B. FERC Has Not Lifted Price Controls On Pipeline Capacity

FERC-imposed price controls on interstate pipeline capacity have not been lifted. FERC continues to regulate the rates for upstream capacity. In Order No. 637,[2] FERC removed the price caps on short-term (less than a year) released capacity on a temporary, experimental basis beginning March 27, 2000.[3] When the experimental period ended on September 30, 2002, FERC declined to extend the removal of price caps on short-term upstream capacity. As a result, capacity cannot be released at rates that exceed the pipelines' maximum rates.

Other restrictions by FERC continue to manifest its assessment that the upstream capacity market has not become sufficiently competitive and that the continuation of regulatory protections is necessary. Thus, FERC continues to enforce the shipper-must-have-title rule. In Atlanta Gas Light Co., 100 FERC ¶ 61,071 at 61,278 (2002), FERC affirmed that pipeline customers may not broker or assign capacity outside of FERC's capacity release program. And FERC continues to grant a priority to primary point shippers. In Order No. 637, FERC affirmed that primary point capacity holders have a scheduling priority over secondary point holders. Order No. 637, at 31, 304-305.

Other developments have also tended to tighten rather than broaden the upstream capacity market. In the wake of the Enron bankruptcy, many pipelines have sought to tighten their creditworthiness standards, making it more onerous for replacement shippers (i.e., marketers) to obtain capacity in the secondary market. See Tennessee Gas Pipeline Co., 102

[2] Regulation of Short-Term Natural Gas Transportation Services, Docket No. RM98-10-000 and Regulation of Interstate Natural Gas Transportation Services, Docket No. RM98-12-000 (February 9, 2000) and respective orders on rehearing, Order 637-A (May 19, 2000) and Order 637-B (July 26, 2000).

[3] The price caps on long-term released capacity were not removed.

FERC ¶ 61,075 (2003). This controversy over creditworthiness has caused FERC to issue a Notice of Proposed Rulemaking on creditworthiness issues: Creditworthiness Standards for Interstate Natural Gas Pipelines, 106 FERC ¶ 61,123 (2004).

It is not possible to say with certainty what changes FERC may ultimately require in the development and enforcement of creditworthiness criteria. However, the Department can be certain that under mandatory capacity assignment, if a third-party supplier defaults, the marketer's pipeline capacity initially under contract by the LDC to serve Massachusetts customers will continue to do so because that capacity ultimately will revert to a Massachusetts LDC.

C. The Number of Marketers Holding Firm Upstream Capacity Rights Has Not Increased

As addressed below, the number of marketers operating in KeySpan's service territory has decreased from 21 just prior to the time the Department issued its order in Natural Gas Unbundling to just 11 today. Of the remaining marketers, few offer services to all commercial and industrial customer classifications. The unbundling of residential customers is virtually non-existent.

It is KeySpan's understanding that, although several pipeline projects have been announced since the implementation of state-wide customer choice in 2000, marketers have not signed up for new capacity on any of these pipelines for service to Massachusetts customers. Therefore, it is KeySpan's understanding that the number of marketers who hold firm upstream capacity rights has not increased.

D. Conclusion

Since these two preconditions clearly stated by the Department in its order in D.T.E. 98-32-B have not been met, the upstream capacity market cannot be considered sufficiently competitive to allow for the introduction of voluntary capacity assignment. Therefore, no modification or change to mandatory, slice-of-system, capacity assignment should be made at this time.

IV. Mandatory, Slice-of-System, Capacity Assignment Continues to Provide an Appropriate Interim Solution

Mandatory, slice-of-system, capacity assignment continues to assure reliable gas service to all customers and an equitable assignment of costs. By assigning capacity to marketers on behalf of their customers, mandatory assignment ensures that there is enough capacity to provide peak day and peak season deliverability to meet demand on the Massachusetts LDCs' systems. And by requiring the slice-of-system approach, as opposed to the path approach, the LDCs' reliability planning and the equitable allocation of capacity costs have not been disrupted by selective "cherry picking" of capacity by marketers.

FERC's continued price regulation and its continued close regulation of the terms and conditions of the capacity market reflect its assessment that a competitive capacity market has not developed. And this insufficiency is particularly acute at the city gates serving Massachusetts because of their geographical location at the furthest delivery points of the two major pipelines that serve the Commonwealth and the comparative high winter peak loads in Massachusetts. The interstate pipelines serving Massachusetts operate at or near their capacity throughout the winter season, with the Massachusetts LDCs having to rely heavily on downstream storage and production assets to meet peak load demand.

Moreover, FERC's regulations are designed to provide protections to natural gas customers because the current upstream capacity market is not sufficiently competitive. While these federal protections remain in place, voluntary capacity assignment for marketers would provide them economic incentives that conflict with the welfare of natural gas customers in

Massachusetts. Because pipelines operate at capacity during peak periods, the effect of FERC's price cap is to under-value capacity during much of the winter season. And, since FERC allows the pipelines to recover these costs over the course of a full year, capacity is over-valued for much of the non-peak period.

Under the present mandatory capacity assignment program, the LDC releases capacity with recall rights to marketers and the marketers are obligated to accept the capacity. If a marketer were to fail to perform, the LDC -- because of recall rights -- then has access to that capacity to guarantee continuity of service to that marketer's customers. In contrast, under a voluntary assignment program, when the LDC no longer has any recall rights, a marketer has several options that could undermine this guarantee of continued service. First, a marketer would have the option to not accept the LDC's released capacity. If a marketer chooses not to accept the capacity, then the LDC may choose to release the capacity associated with serving the marketer's customers so that its remaining firm sales customers would not be burdened with the cost of what might be "excess capacity." Should the marketer then fail to otherwise procure capacity needed to serve its customers, since neither the marketer nor the LDC would have recall rights for the released capacity, the capacity to the LDC's city gates might not be sufficient. Second, a marketer with no absolute obligation to serve customers in the Massachusetts market with the existing capacity could find a strong economic incentive to sell its capacity in other geographical locations, regardless of its contract with its Massachusetts customers. This also could endanger reliability of supply in Massachusetts.

Similarly, with respect to the issue of the creditworthiness of third-party suppliers, without mandatory capacity assignment, a defaulting marketer's pipeline capacity held for the marketer's Massachusetts customers may be lost because the capacity would not be under contract by the LDCs. This lost capacity may be irreplaceable.

Until the capacity market is sufficiently developed, only mandatory capacity assignment will preserve system reliability. With Massachusetts LDCs continuing to hold contractual rights for the vast majority of the primary capacity, mandatory capacity assignment ensures that gas will flow to Massachusetts customers.

The slice-of-system approach additionally has prevented unfair cost shifting to the remaining sales customers.[4] Similar to the cost-shifting and reliability concerns necessitating mandatory assignment, under the slice-of-system approach marketers have been prevented from choosing the least-expensive "paths" of capacity that would shift the more-expensive capacity to the firm sales customers or deny them assets of greater reliability.

Thus, under the current approach, no customer has been placed at a disadvantage as a result of moving from sales to transportation service. Likewise, no firm sales customers have been disadvantaged as a result of unbundling. Mandatory, slice-of-system, capacity assignment has succeeded in appropriately balancing the Department's stated goals of service reliability with fair allocation of costs to customers. At the same time, the costs of capacity have been spread equitably across marketers chosen by customers. Therefore, all marketers are faced with the same cost structure with regard to upstream capacity. Mandatory capacity assignment ensures that all marketers competing on an LDC's system pay equivalent prices for the capacity they utilize – the same rates paid by KeySpan. And, whereas the mandatory approach assures that marketers pay equivalent prices, the slice-of-system approach assures that the assets for which they are paying are also made available to all marketers on an equitable basis.

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[4] Because marketers have not been targeting residential customers, they comprise the vast majority of the captive customers.

V. Additional Data Requested by the Department

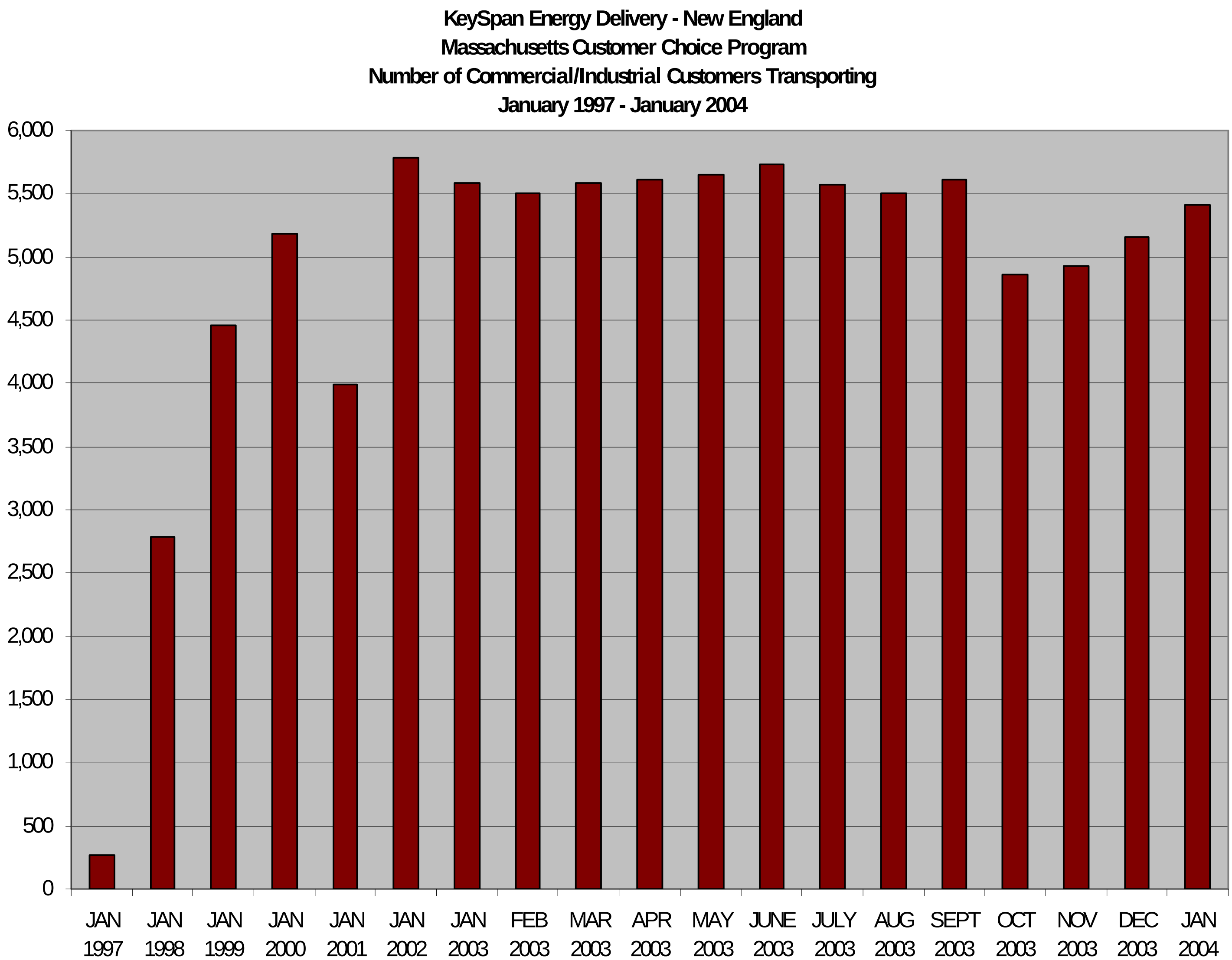
In seeking comments on whether there should be any modification or change to mandatory capacity assignment, the Department requested specific information. Except for that provided above, that information follows:

A. Inclusion of Marketers in an LDC's Capacity Planning Process

Since 1999, KeySpan has sent letters annually to all marketers serving customers in KeySpan's Massachusetts service territories to inform them of upcoming capacity contract decisions and has requested their input or comments on the renewals of capacity contracts. In addition, KeySpan hosts an annual Supplier Meeting to discuss, among other things, changes to the Company's supply and capacity portfolio. Marketers have attended and participated in these annual meetings with the Company.

B. Number of Transportation Customers

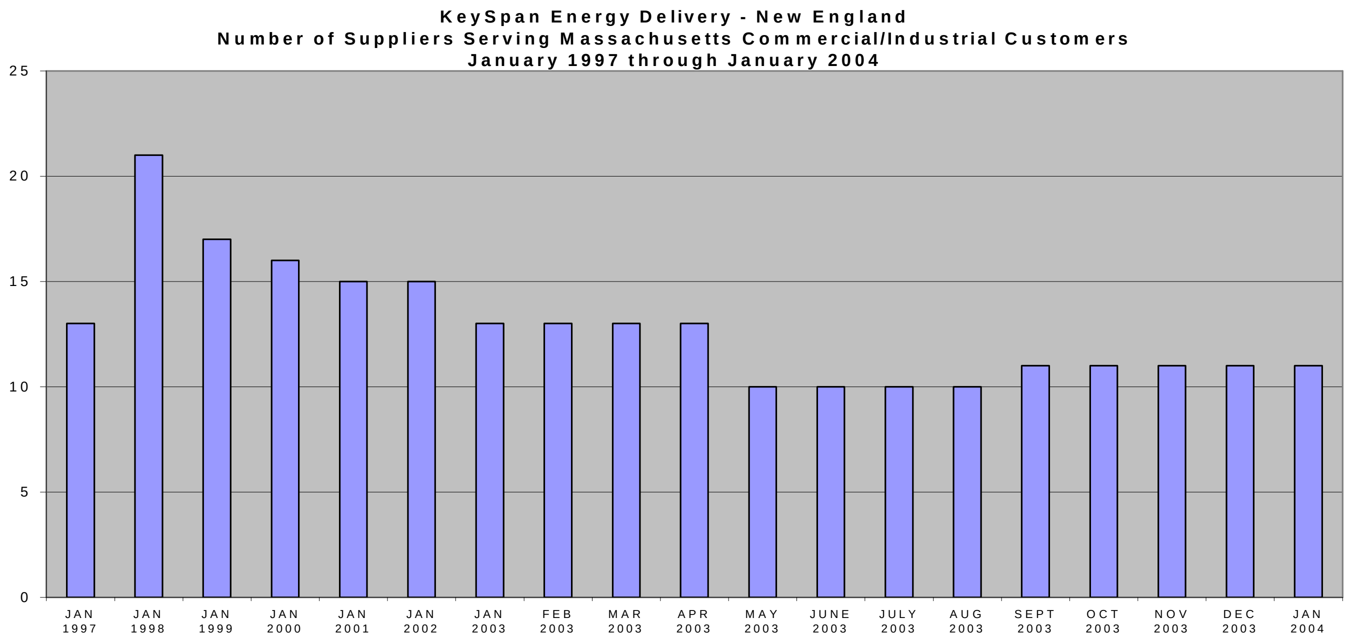
The graph below shows the number of KeySpan's transportation customers taking service from marketers as of January of each year indicated and for each month over the past year.



The number of customers prior to January 2000 represents Boston Gas Company only. Essex and Colonial C&I customers are included in January 2000 and thereafter.

C. Number of Marketers

The number of marketers providing service in KeySpan's Massachusetts service territory is shown below as of January of each year and for each month over the past year. Based on information from marketers, KeySpan anticipates that after the expiration of existing marketer contracts in the spring of 2004, there will be eight marketers providing service in KeySpan's Massachusetts service territory.



D. Percentage of the Market Converted to Transportation Service by Volume and Number of Customers

The following table shows the percentage of the market that has converted to transportation service by volume and by number of customers, as of January of each year.

Table 3		
January/Year	Percent C&I Normalized Volume	Percent of C&I Customers
1999*	32.04*	11.49*
2000	37.72	8.08
2001	36.81	6.09
2002	45.90	8.54
2003	43.97	7.63

*Represents Boston Gas Company only. Subsequent years include Essex and Colonial Gas C&I customers.

VI. Conclusion

The upstream capacity market at this time is not sufficiently competitive for the Department to consider modifying the existing mandatory, slice-of-system, capacity assignment method. Until the preconditions set out by the Department have been met and there is a sustainable competitive upstream capacity market, LDCs must continue to assure reliable capacity and supply at reasonable cost for all customers. It is through the continuation of mandatory capacity assignment that this best can be accomplished. And for all the reasons that the Department stated in D.T.E. 98-32-B, the continuation of mandatory assignment concomitantly requires the continuation of the slice-of-system approach to capacity assignment.

KeySpan thanks the Department for the opportunity to address this issue.

Respectfully submitted,
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By its attorney,

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